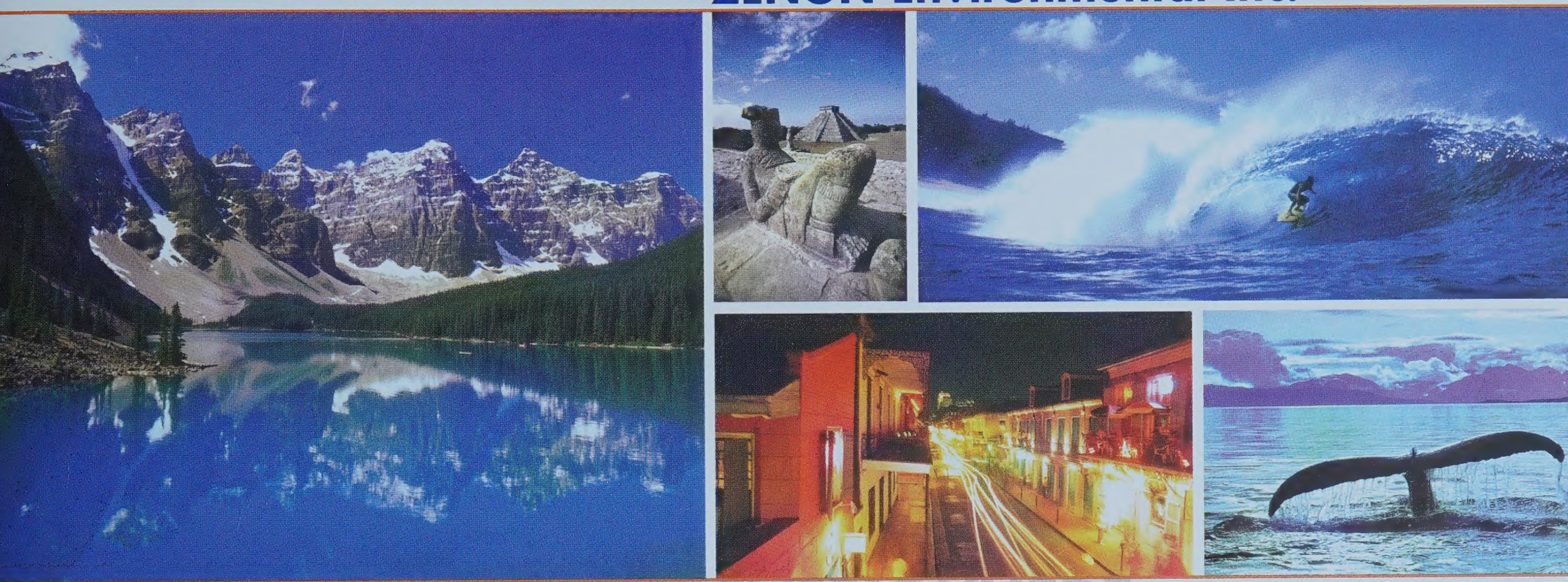
2001 Annual Report

ZENON Environmental Inc.



Everywhere EVERYWHERE

WATER FILTRATION SOLUTIONS

ZENON®

Water for the World

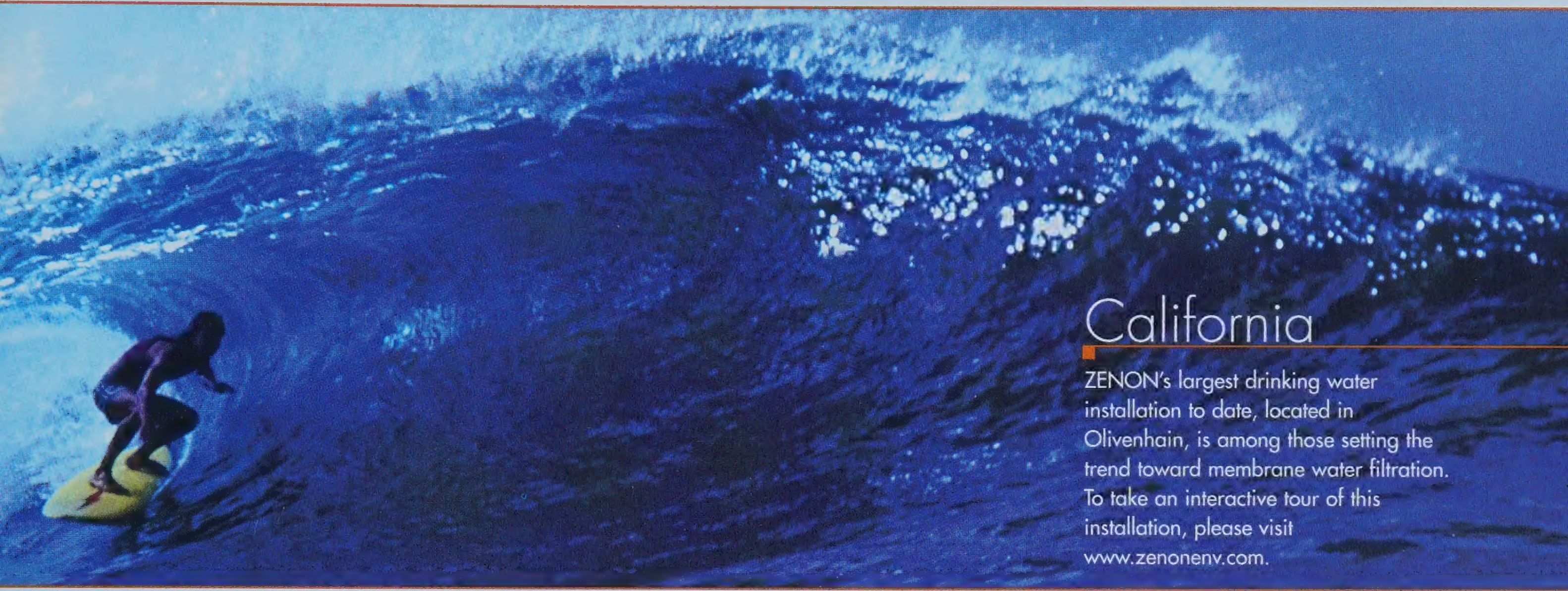
Corporate Profile

ZENON Environmental Inc. is an international leader in manufacturing and marketing membrane-based water filtration technologies. We specialize in purifying drinking water to superior levels of quality, treating wastewater for safe discharge into the environment, and recycling water for reuse in irrigation.

ZENON's customers are international in scope, and include municipalities, industries, government agencies, land developers, and ship owners. Established in 1980, we now have 17 offices located in 11 countries. Our offices and representatives can be found in nine locations in North America, six in Europe, and one in each of Asia, Latin America, and the Middle East.

We are committed to addressing the growing worldwide concern over water quality, and to solving critical water and wastewater problems. Our goal is to set higher standards for water and wastewater treatment, while dramatically reducing energy and chemical requirements.

ZENON adds value by continuing to develop products that extend the applications of our technology over a wider range of market sectors and project sizes. Ongoing investment in research and development has produced and commercialized many world leading technologies, such as the ZeeWeed® membrane and the ZenoGem® membrane bioreactor.



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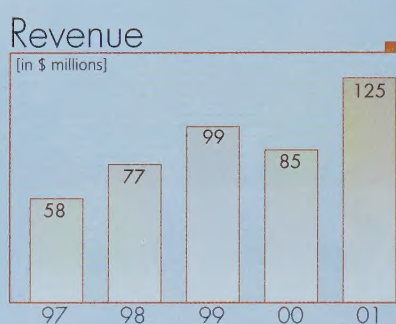
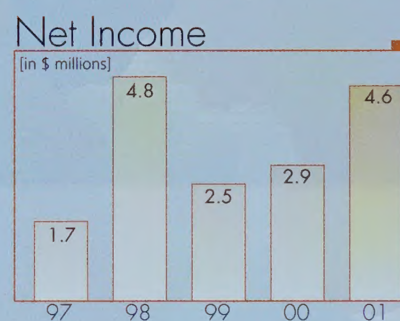
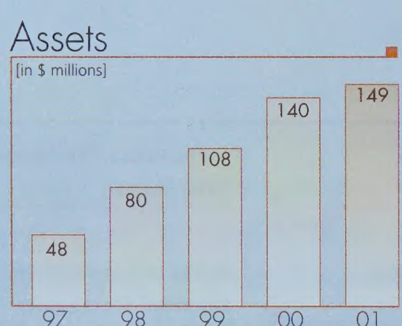
Financial Highlights

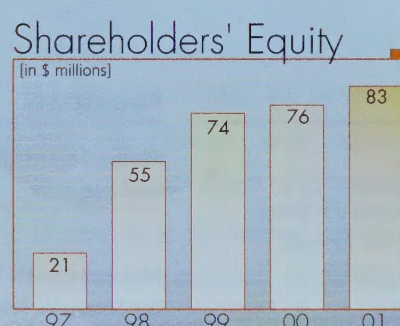
For the years ended December 31

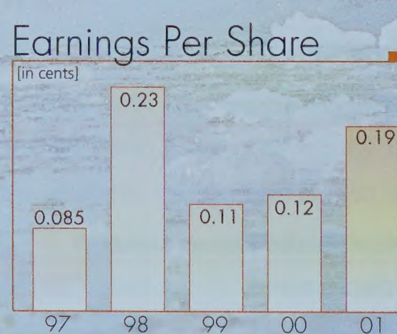
	2001 $	[000's except earnings per share]	2000 $
Total Revenue	**124,711**		84,476
Operating Income (before unusual items and taxes)	**6,911**		(7,332)
Net Income	**4,621**		2,895
Net Income Per Common Share	**0.19**		0.12
Total Shareholders' Equity	**83,338**		76,061











1997 to 1999 figures adjusted to reflect 2-for-1 share split.

Alaska

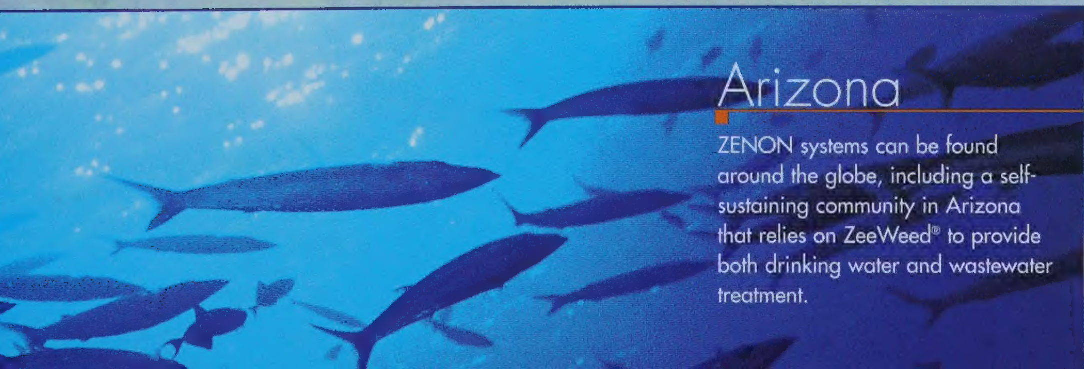
ZeeWeed® technology is providing onboard wastewater treatment solutions for the cruise ship industry, protecting and preserving sensitive marine environments.

Five-Year Historical Review

KEY STATISTICS

Years ended December 31	**2001** **$**	2000 $	1999 $	1998 $	1997 $
OPERATING RESULTS [000's]					
Revenue	**124,711**	84,476	98,755	77,211	58,428
Gross profit	**47,924**	28,100	35,147	29,944	21,493
Net income	**4,621**	2,895	2,464	4,789	1,656
Cash flow from (used in) operations	**38,651**	(4,323)	(6,479)	(3,509)	384
FINANCIAL POSITION [000's]					
Cash position	**5,517**	4,203	8,676	12,752	2,074
Total assets	**148,785**	139,651	108,052	80,358	48,294
Current bank indebtedness	**529**	25,020	5,673	1,967	5,739
Shareholders' equity	**83,338**	76,061	73,558	54,916	21,423
Working capital	**30,832**	28,559	39,537	32,712	5,971
PER SHARE DATA *					
Net income per share					
- Basic	**0.19**	0.12	0.11	0.23	0.09
- Fully diluted	**0.19**	0.12	0.10	0.22	0.08
Market price					
Common shares (ZEN)					
- High	**17.15**	12.50	20.75	14.43	8.15
- Low	**6.90**	5.60	7.50	6.75	4.13
- Close December 31	**16.46**	7.25	12.00	13.25	7.13
Non-voting Class A shares (ZEN.A) **					
- High	**12.99**	10.00	18.30	13.00	---
- Low	**3.80**	3.25	6.50	8.38	---
- Close December 31	**12.00**	3.90	11.00	13.00	---
OTHER					
Total number of employees	**634**	501	464	375	298
Number of employees in R&D	**54**	49	36	34	13
Common shares outstanding ***					
- end of year	**20,413,752**	19,795,642	19,543,292	19,516,712	19,464,920
- weighted average	**19,983,165**	19,695,000	19,484,200	19,410,958	19,401,590
Non-voting Class A shares outstanding ***					
- end of year	**3,900,000**	3,900,000	3,900,000	2,800,000	---
- weighted average	**3,900,000**	3,900,000	3,523,112	1,189,042	---

* reflects 2-for-1 share split, rounded to nearest cent
** convertible into common shares on a share-for-share basis on June 10, 2008
*** reflects 2-for-1 share split



Arizona

ZENON systems can be found around the globe, including a self-sustaining community in Arizona that relies on ZeeWeed® to provide both drinking water and wastewater treatment.

Letter to Shareholders

Ever since ZENON became a public company, we have told our shareholders that:

1) **Membranes will ultimately replace a significant fraction of the clarifiers and sand filters used in conventional water and wastewater treatment; and that ZENON will be the global leader in the resulting membrane market.**

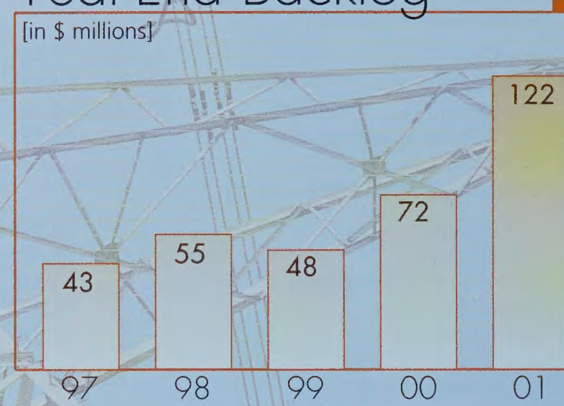
2) **Over time, ZENON will gradually become more and more profitable, and our growth in revenue and profit will translate to a significantly increasing share price on a long-term basis.**

In 2001, we have shown even the skeptics that at ZENON we deliver on our promises.

It is now clear to everyone in the water industry that membranes are becoming a reliable and cost effective alternative to conventional water treatment. Municipal drinking water and wastewater treatment plants are now rapidly shifting to membrane technology; industrial pure water and wastewater plants are increasingly being built with membranes; and membranes are becoming the unanimous choice for water reuse. The market is now clearly starting to accelerate toward the near vertical part of the hockey stick.

Where is ZENON in this accelerating market? We believe that we are the market leader in North America and Europe, and in a few years we will also become the leader in Asia. One indication of this leadership is our order backlog, which has grown nearly 70% year-over-year for the last two years, and is now at an all time high of $122 million.

Year-End Backlog



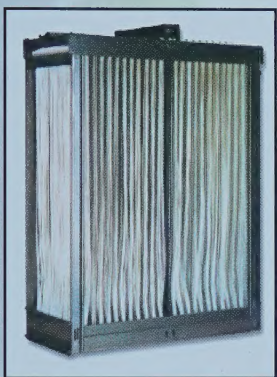
The reason for our leadership is the ZeeWeed® technology, the world's most successful commercial membrane product for water filtration. The ZeeWeed® family of membranes is a unique proprietary group of products that have become more and more cost effective, and as a result more customers can afford to buy it.

"The market is now clearly starting to accelerate toward the near vertical part of the hockey stick."

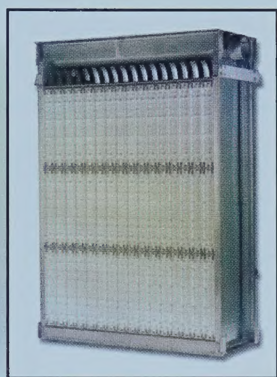
Alberta

ZENON's membrane technology is the key to cost-effective and reliable boiler feed water supply for companies in the power generation industry as well as refineries.

There are two types of ZeeWeed® sold: the ZeeWeed® 500 series, which have been manufactured for more than ten years, and the ZeeWeed® 1000, which was introduced a little over a year ago. Both of these products are thriving in the global water treatment scene, with the ZeeWeed® 1000 enjoying a relatively rapid market penetration. We are dedicated to continuing to evolve both product series over the long term, thereby ensuring market and technology leadership.

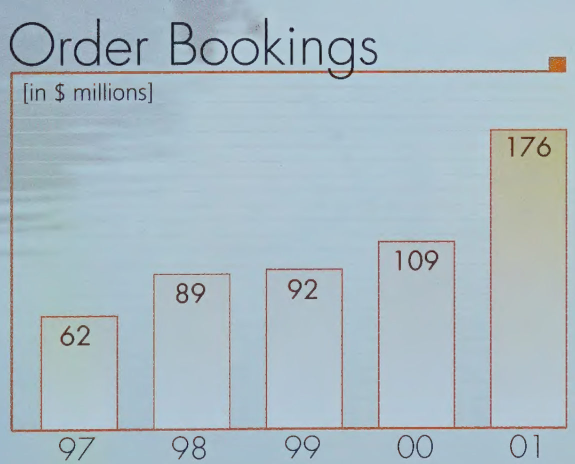


ZeeWeed® 500



ZeeWeed® 1000

Our current order backlog includes many exciting applications of the technology in a number of countries, with significant market growth opportunities to follow. These new orders, coupled with our existing installation base, mean that ZeeWeed® will truly be everywhere.



Examples of these exciting applications and locations are as follows:

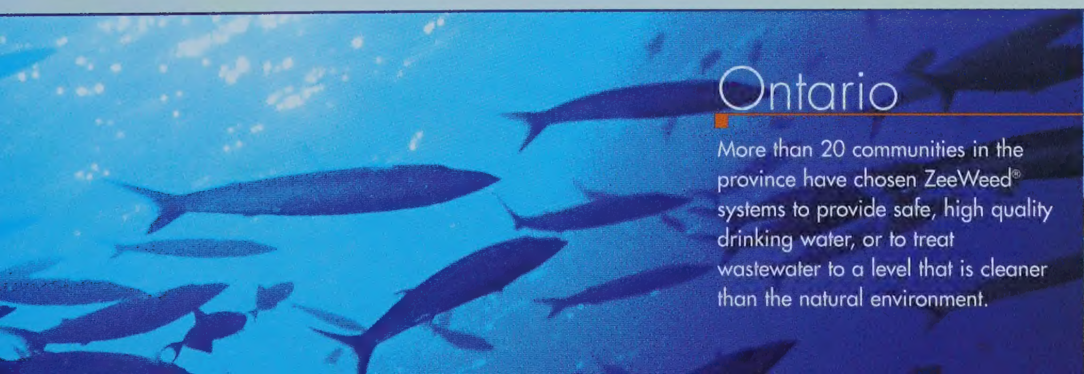
(i) In municipal drinking water, there has been a rapid shift to ZeeWeed® technology in the United States and Canada, and now this trend is starting to be followed with plants in Europe (i.e., Germany, Hungary, Poland). Our current orders in all regions, but especially Europe, are only the tip of the iceberg.

(ii) Our municipal wastewater treatment business increased significantly last year, particularly in Europe where in May we announced the world's largest plant in Italy, and then we beat our own record a few months later with an even bigger plant in Germany.

(iii) In 2001, we enjoyed a large number of significant orders in the power industry (mainly in the United States and Canada), the semiconductor industry (Korea, Taiwan, Malaysia), the food industry (Germany, France, United States), and the pharmaceutical industry (Germany, Italy, Ireland). In each of the above markets much more business can be developed.

(iv) In water reuse, we are building plants that recycle water - for irrigation (United States), for drinking water (Belgium), and for electronic fabrication (Singapore). This market is still in its infancy; however, we believe that with water shortages spreading around the world, this application is very promising.

We also had a remarkable year in terms of improvement in profitability. Through a combination of rapid revenue growth and a single-minded focus on membrane systems, we have achieved a new level of scale in all aspects of manufacturing and distribution, resulting in efficiencies in material procurement, engineering, and production. We have also been able to leverage our scale by growing selling, general and administrative (SG&A) expenses at a slower rate than revenue, which resulted in an SG&A percentage of 24.7% of revenue – the lowest in ZENON history.



Ontario

More than 20 communities in the province have chosen ZeeWeed® systems to provide safe, high quality drinking water, or to treat wastewater to a level that is cleaner than the natural environment.

In addition, new systems and design tools are enhancing the ability of our engineers, programmers, and drafters to replicate standard designs and perform computer simulations of membrane plant performance. The further implementation of an Enterprise Resource Planning System has allowed management to track costs of all active projects in real-time, resulting in improved project execution, and directly contributing to our year-over-year turnaround from a $7 million operating loss to a near $7 million operating profit.

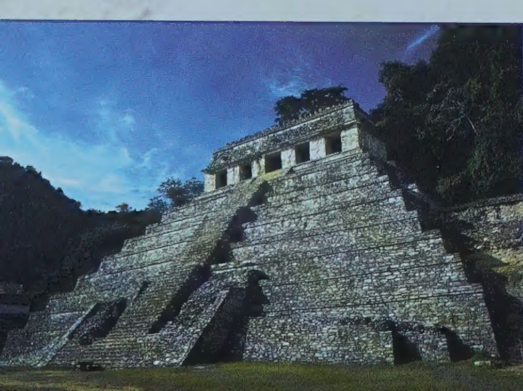
"... the most cost effective producer of membranes for water and wastewater treatment."

While ZENON continues to follow its strategy of focusing exclusively on membrane-based water purification systems, within our narrow business focus, we continue to increase our service capabilities to better serve our customer base. 2001 marked the roll-out of our next generation of remote monitoring tools, which allow for real-time monitoring and analysis of all aspects of ZeeWeed® plant performance over the Internet, from anywhere in the world. To ensure that our customers will be able to look to ZENON for a lifetime of service support, we have recently established a new business unit dedicated to service over the lifecycle of our plants. These new capabilities contributed to a doubling of the number of North American plants with service agreements in 2001.

One of our most significant operational achievements last year can be found on our Balance Sheets and Statements of Cash Flows. With an increased focus on cash management, ZENON generated over $38 million in operating cash flow as non-cash working capital decreased, despite a major growth in revenue. The cash was used to virtually eliminate our line of credit debt, which decreased from $25 million to $0.5 million, and to invest in capital equipment as we doubled our membrane manufacturing capacity in 2001. With this improved financial position, shareholders can be assured that the bulk of future capital injections will be used to increase manufacturing capacity, rather than being invested in working capital.

To meet the increasing demands for membrane technology, ZENON embarked on its most ambitious membrane capacity expansion program in its history. Near the end of 2001, we initiated construction of a second membrane manufacturing plant in Hungary. By the end of 2002, this plant will more than double ZENON's membrane manufacturing capacity, with expansion room within the building to double capacity again when required. This facility will incorporate automated state-of-the-art manufacturing equipment based on the proven designs of our Ontario plant.

As a result of all of these positive developments, our share price rose dramatically in 2001. Some of this rise compensated for a decrease in share price due to a temporary lull in the development of our markets in 1999, and subsequent stagnation in our share price while the dot.com craze was overtaking the stock market.

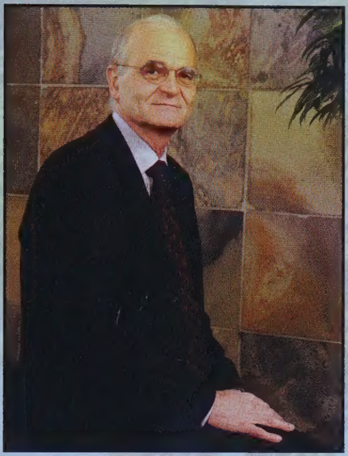


Mexico

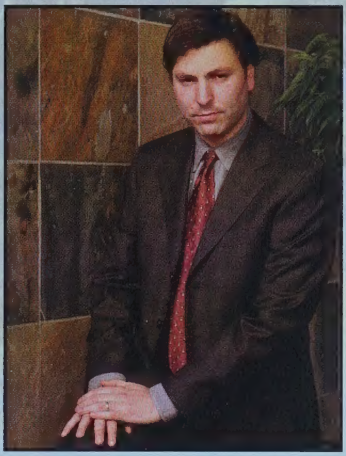
ZeeWeed® is at the heart of many water reuse facilities that provide advantages for industries, including a Mexican oil refinery that now reuses nearly 7 million gallons of wastewater a day.

Our challenge now is to maintain our momentum. We will achieve this by continuing to adhere to the business model we have developed (i.e., being the most cost effective producer of membranes for water and wastewater treatment), by hiring and training the best people in the industry, and continuously improving every aspect of our operations, with a constant focus on customer service and profit.

In closing, we want to thank our customers, shareholders, and employees for their ongoing support of ZENON's vision; a vision which, in addition to benefitting all of our stakeholders, will result in a solution to the world's water problems.

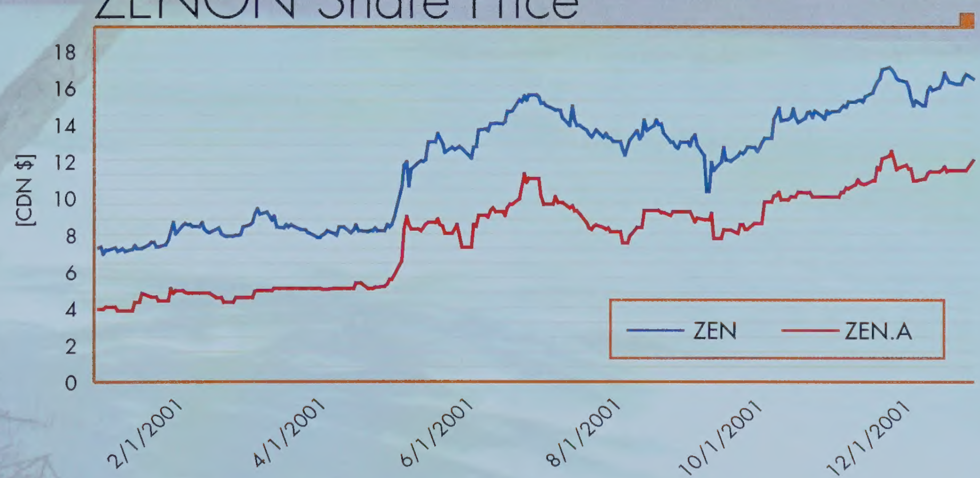


Andrew Benedek
Chairman and Chief Executive Officer



Rafael Simon
Chief Operating Officer

ZENON Share Price



Puerto Rico

Throughout the Caribbean, ZeeWeed® is providing effective treatment of drinking water and wastewater for resorts, allowing growth and development of local economies while protecting the natural environment.

Management's Discussion & Analysis

The following Management's Discussion and Analysis provides information that the Company believes is relevant to an assessment and understanding of the Company's consolidated results of operations and financial condition. This discussion should be read in conjunction with the Consolidated Financial Statements and accompanying notes. Certain statements contained in the Management's Discussion and Analysis of financial condition and results of operations contain forward-looking statements, relating to the operations or to the environment in which we operate, which are based on our operations, forecasts, and projections. Forward-looking statements are not guarantees of future performance. They involve risks, uncertainties and assumptions, and the Company's actual results may differ materially from those anticipated in these forward-looking statements.

Key Operating Information ($ in millions)

	2001	2000	Increase (Decrease) %
Backlog	**122**	72	69
Order Bookings	**176**	109	61
Revenue	**124.7**	84.5	48
Gross Profit as % of Revenue	**38.4%**	33.3%	15
Selling, General & Administrative as % of Revenue	**24.7%**	31.2%	(21)
Operating Income Before Tax	**6.9**	3.4	103
Net Income	**4.6**	2.9	60
Total Employees	**634**	501	27

The benefits of the investments made in employees and capital assets have started to show results in 2001, with record revenues and record operating profit.

Revenue for the year ended December 31, 2001 was $124.7 million, an increase of 47.6% over the previous year of $84.5 million. Revenue growth reflects increasing demand for ZENON's membrane technology, which is supported by the highest year-end backlog in the Company's history.

The backlog at December 31, 2001 of $122 million is 69% higher than the $72 million backlog reported at the end of 2000. Booking of new orders for 2001 was $176 million, a 61% increase over fiscal 2000. Both the backlog and booking of new orders set record highs for the Company.

The Company had strong revenue growth in 2001 reflecting the increasing demand for clean water solutions. In Canada, revenues increased 33% to $41.3 million; in the Unites States revenues increased 66% to $53.7 million; and

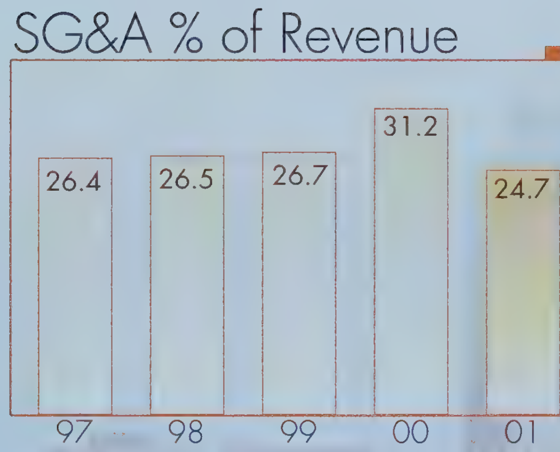
Brazil

By meeting stringent environmental regulations in the cosmetics industry, ZeeWeed® is contributing to continued economic development, while ensuring a high quality end-product for consumers.

International revenues increased by 40% to $29.7 million. Included in the International figure is revenue resulting from management negotiating the cancellation of a contractual arrangement, which accounted for approximately 10% of the region's revenue. ZENON regularly enters into distribution agreements that allow distributors to assemble and sell water and wastewater treatment systems using ZENON's proprietary membranes. Included in revenues for 2001 is $2.9 million (2000-$1.4 million) relating to these agreements. The ongoing sale of such agreements reflects the continuously increasing demand for the ZeeWeed® technology, which in turn strengthens ZENON's position worldwide, and supports the Company's continued revenue growth in the future.

The gross profit as a percentage of revenue in 2001 was 38.4% compared to 33.3% in 2000. Improved controls over project costs, continued standardization of product components, and diligent negotiating by management, including the contract cancellation arrangement, have resulted in improved margins in 2001. Offsetting these improvements were the ongoing investments in pilot plants and discounts required for penetration into certain strategic market sectors, as well as an increase in warranty provisions. During the year, management increased its warranty provision by $2.0 million to reflect the risk relating to the increasing number of membranes being used by its customers. To date, the Company has experienced minimal warranty claims; however, the marketplace is demanding longer warranty periods, and management believes it is prudent to increase the provision for this potential risk.

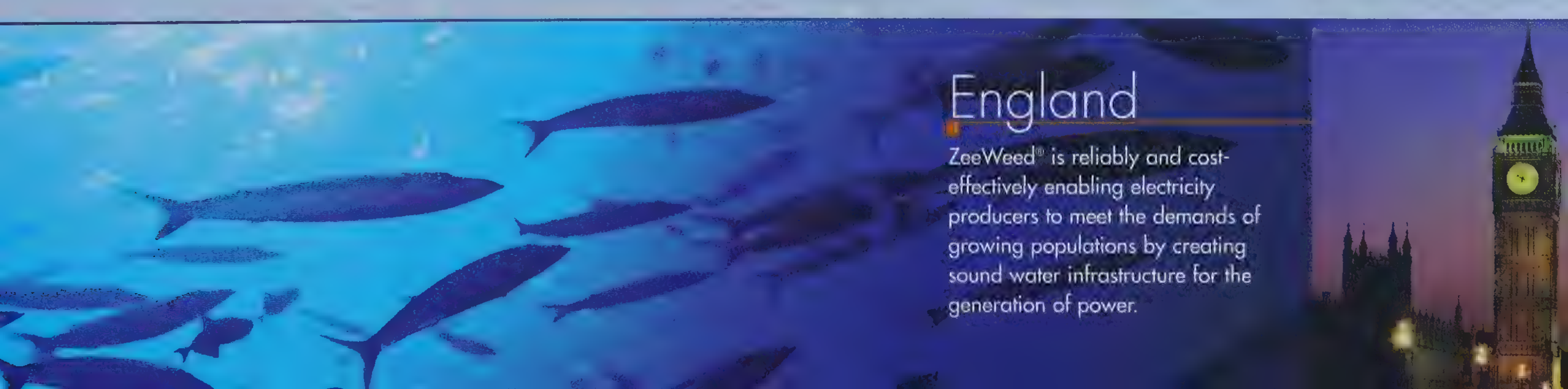
Selling, general and administrative (SG&A) expenses were $30.8 million in 2001, an increase of 16.9% over 2000. SG&A costs, as a percent of revenue in 2001 were 24.7% compared to 31.2% in 2000. The improvement in SG&A as a percent of revenue reflects management's commitment



to contain overheads at a lower rate of growth than revenue and bookings. In 2000, SG&A included $724,000 of severance costs relating to the restructuring of its management team. There were no significant similar costs included in 2001. ZENON increased its staff in 2001 by 133 people, for a total of 634 employees at year-end. The majority of this increase relates to the production activity required to match the revenue growth.

Research and development continues to be a significant investment for the Company. ZENON's investment of $6.9 million in 2001 slightly exceeded that made in 2000. Of the $6.9 million, $4.6 million has been received or is receivable from external funding, resulting in a net expenditure of $2.3 million in 2001, compared to a net expenditure of $2.8 million in 2000.

Ongoing innovation is a major driver contributing to the Company's competitive advantage. In light of ZENON's technological contributions to date and to further these developments, in 2000, ZENON was awarded a $9.9 million repayable grant (to be received over three years) from Technology Partnerships Canada for advanced research into improving energy efficiency and performance standards in

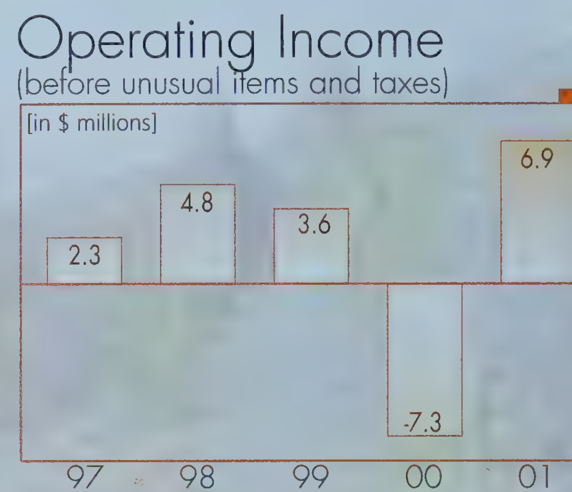


membrane–based water treatment. To date, the Company has claimed $6.2 million ($3.3 million in 2001), of which $3.5 million has been received and $2.7 million is reflected as accounts receivable. Of the $6.2 million claimed, $5 million is reflected on the consolidated balance sheet as a deferred technology credit and the balance of $1.2 million is an offset to other assets. ZENON's strong focus on research and development will allow the Company to maintain its market leadership in membrane-based water technology.

Effective January 1, 2000 the Company changed its method of accounting for Income Taxes from the deferred method to the liability method of tax allocation, as required by the Canadian Institute of Chartered Accountants' section 3465 "Accounting for Income Taxes".

During the 2000 fiscal year, future income tax assets of $3.8 million were recorded. As a result of the profitability of the Company in 2001, this asset has been reduced to $1.9 million. Management continues to believe that based on the Company's prior performance and its plans going forward, the balance of this tax asset will be utilized. The minimum amount of future taxable income that is required in order to realize this future tax asset is $5 million. Provision for income taxes at an effective rate of 33.1% (2000-14.8%) reflects the overall improvement to operating profit, and to an improvement in the geographical distribution of profits.

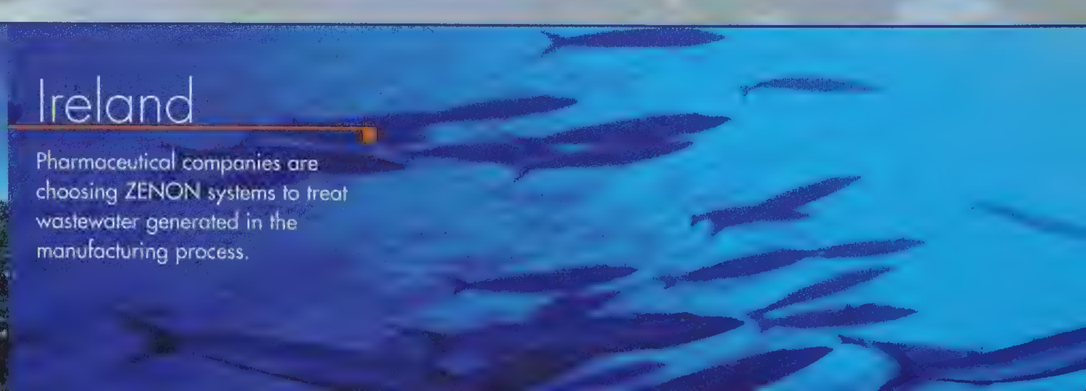
Operating income before income tax of $6.9 million was a record for the Company. This was a significant improvement from the loss before gain on the settlement agreement of $7.3 million recorded in 2000. In 2000, the Company had a gain from a settlement agreement that improved the operating loss by $10.7 million.



Net income for the year of $4.6 million ($0.19 per share) compared favourably to the $2.9 million ($0.12 per share) recorded in 2000. Included in the 2000 net income is the impact of the gain from the settlement agreement. Overall, the Company has shown a major improvement in its operating performance. Management firmly believes that it is in a very strong position to support future growth and profitability. The focus, dedication, and hard work of all employees was a key factor to the success of 2001 and will continue to be one of the main contributors to the success the Company will experience in the future.

Capital Expenditures

During the year, $16.8 million was spent on capital assets compared to $21.5 million in 2000. The major spending areas for 2001 related to membrane capacity expansion and the capital investment in pilot plants to promote membrane technology in the marketplace.



ZENON continued the expansion of its membrane manufacturing plant in Burlington, Ontario, Canada in 2001 and has further invested to increase production capacity at the facility. The Burlington membrane plant will complete this latest round of capacity increase by the end of 2002. Also in 2001, ZENON started construction on a new membrane manufacturing plant in Hungary. This state-of-the-art membrane facility is scheduled to be completed and operational by the end of 2002. The major portion of the expenditure for this investment will occur in 2002.

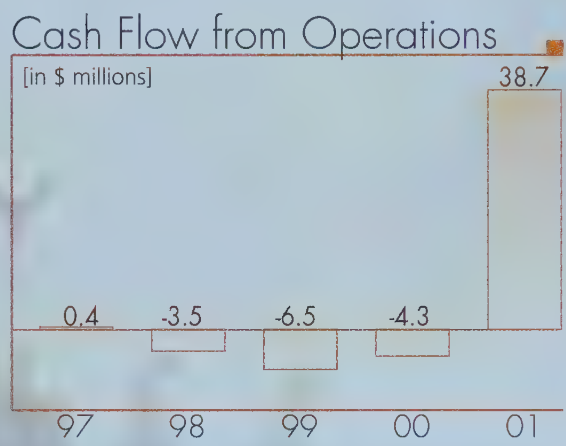
During the latter part of 2001, ZENON also began its capital investment program for the manufacturing equipment to support its new Homespring™ product, which is expected to launch in 2002.

With these expansion initiatives, the Company has positioned itself to support the future growth expectations of the marketplace.

Liquidity

During 2001, the Company renegotiated its credit facilities with certain of its bankers and as of December 31, 2001 it had credit facilities in place totaling $118.6 million, compared to $90 million at the previous year-end. The Company continues to be in compliance with all of its banking covenants. One of management's key focus areas in 2001 was the reduction of debt. At the end of 2001, there were no borrowings on the demand and project financing facilities. Current bank indebtedness was reduced by $24.5 million during the year.

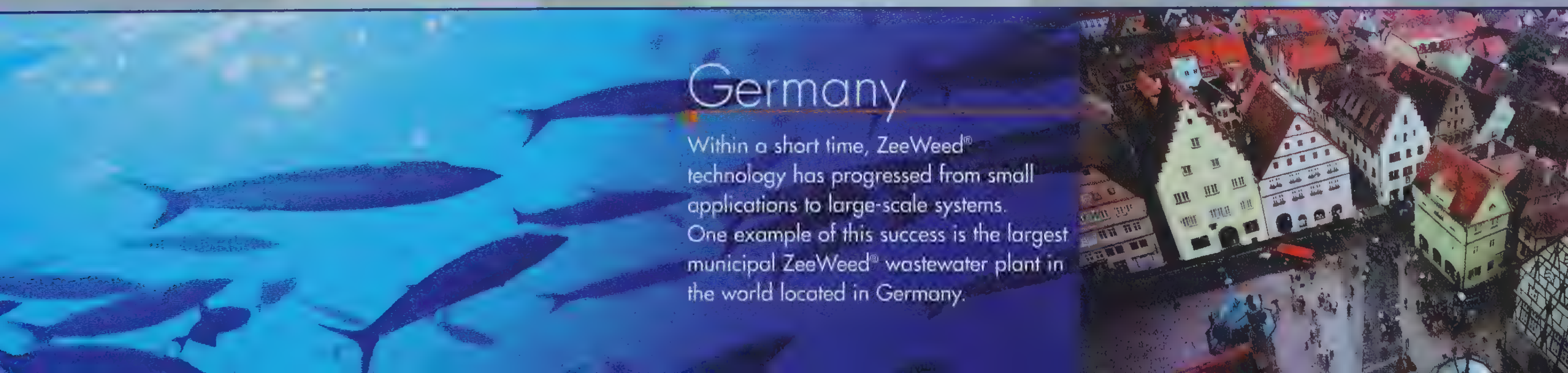
Cash flow provided from operating activities was $38.7 million in 2001 compared to an outflow of cash in 2000 of $4.3 million. The increase in the amount of funds generated from operations is attributable to improved profitability and the attention management gave to controlling non-cash working capital balances. Although revenue increased by 47.6% in 2001, accounts receivable increased by only 6.2% ($2.6 million) and unbilled revenue



decreased by 26.3% ($7.5 million). Through strong cash focus, accounts payable and accrued liabilities increased by $12.3 million and customer advances increased by $9.5 million.

The Company invested $19.9 million to provide the assets required to support the future growth of ZENON. Investment in capital expenditure projects, as previously detailed, totaled $16.8 million in 2001 compared to $21.5 million in 2000. The Company generated $3.0 million in selling off excess equipment compared to $170,000 in 2000. The major part of this disposal relates to the selling of used water processing equipment that had been built by ZENON and was being rented out to its customers.

Patents, goodwill and other assets increased by $6.1 million in the year compared to $681,000 in 2000. The major component of this increase was the investment in the development of new membrane-based water treatment products including the ZeeWeed® 1000, which has been



financially supported by Technology Partnerships Canada.

During the year, employees exercised $2.3 million of stock options in the Company compared to $653,000 in 2000.

The net result of the above cash flows resulted in a decrease in bank indebtedness of $24.5 million and a net increase in cash of $1.3 million.

Management believes that based on its current cash position, along with available credit facilities, future cash flows, and the recent equity issue (referenced under "Outlook"), it will have sufficient funds to meet all of its anticipated cash needs for the financing of the business over the next 12 months.

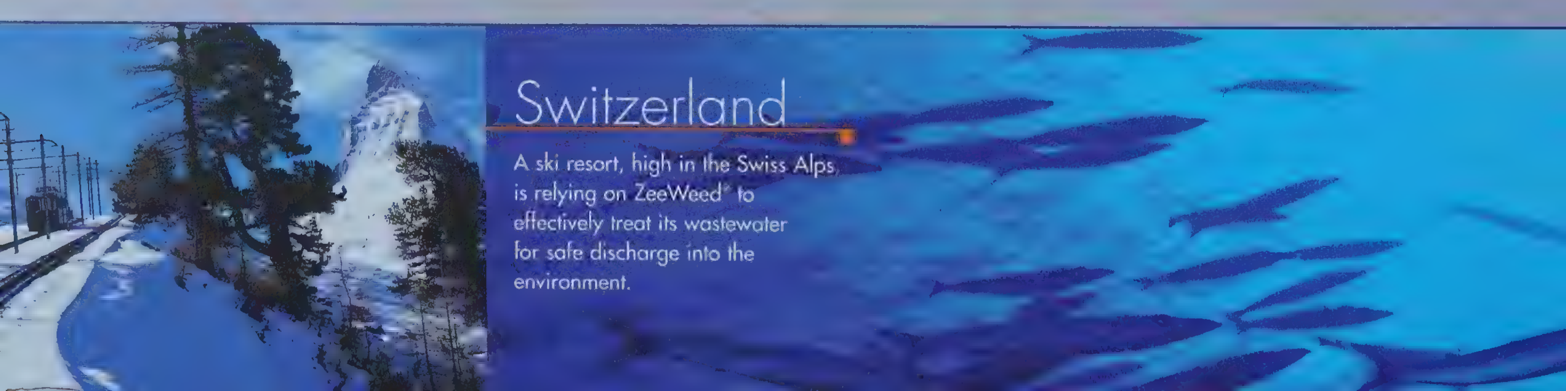
New Accounting Pronouncements

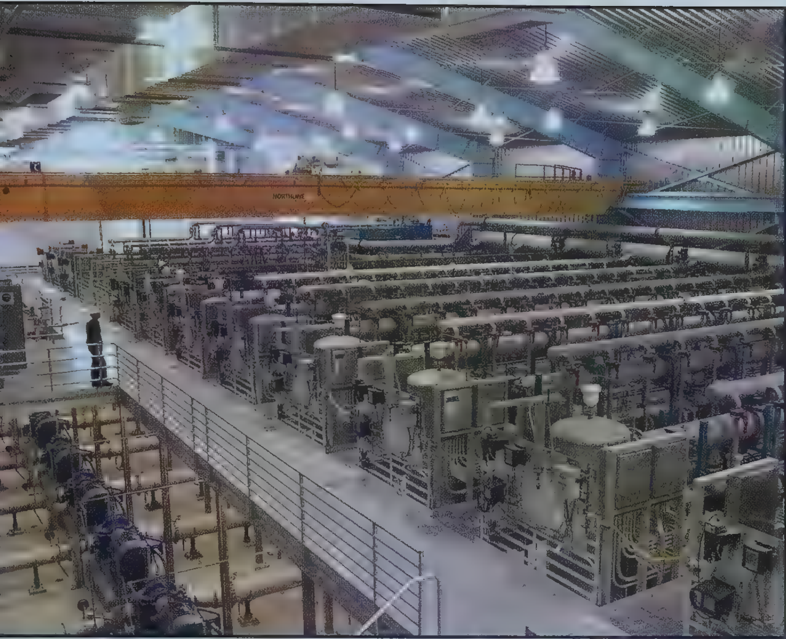
During the year, the Canadian Institute of Chartered Accountants ("CICA") issued CICA 3062 – "Goodwill and Other Intangible Assets". This standard is effective for fiscal years beginning after December 15, 2001, which is the fiscal year beginning January 1, 2002 for the Company. Under this standard, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized, but will be subject to an annual impairment test based on fair values. Other tangible assets will continue to be amortized over their useful lives. An impairment test is required upon adoption of the standard. An impairment loss, if any, will be recorded in the first quarter of 2002 as a change in accounting principle. Since the Company's analysis has not yet been finalized, management cannot assess the impact the adoption of this standard will have on its results of operations or financial position.

Risk Factors

ZENON's success depends on remaining competitive in the development of products, technologies, and services. Membrane technology is an evolving field in which new developments are expected to continue at a rapid pace. Competition in the water and wastewater treatment industry is intense and is expected to increase in each of the Company's market segments, both from within the industry and from those diversifying into the field. As the number and size of installations increase, the potential impact on product warranties rises. Management believes that reasonable warranty reserves are established on an ongoing basis.

The Company is subject to the risks generally associated with new product introductions and applications, including lack of market acceptance, delays in development, and failure of products to operate properly. The market growth potential is subject to certain risks, including costs to develop and commercialize such products; the cost and feasibility of production; the introduction of competing technologies; and market acceptance of the products and technologies involved.





A significant percentage of the Company's revenue is derived from municipal customers. While municipalities represent an important part of the water and wastewater industry, contractor selection processes and funding for projects in the municipal sector entail certain additional risks not typically encountered with industrial and commercial customers. Competition for selection of a municipal contractor typically occurs through a formal bidding process, which can require the commitment of greater resources and longer lead times than industrial projects. In addition, this segment is dependent upon funding availability at the local level, which may be the subject of increasing pressure as local governments are expected to bear a greater share of the cost of public services.

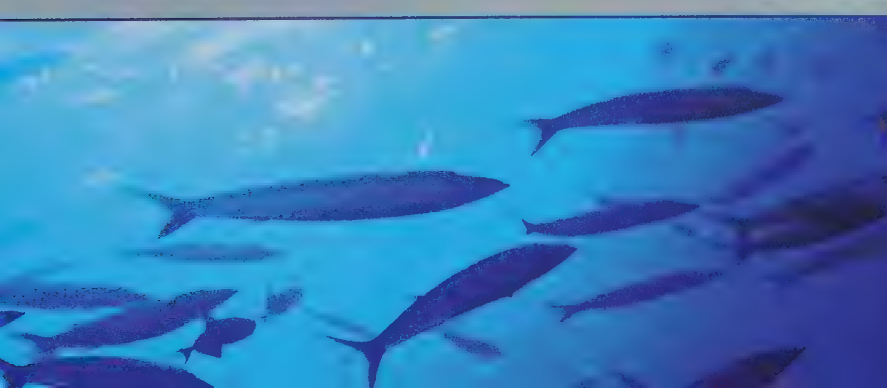
Management believes the Company has financing facilities in place to meet the foreseeable needs of the business.

Outlook

The market for ZENON's technology is expanding, as is the need for safe, pure water. Whether for drinking, manufacturing processes, wastewater treatment for discharge into the environment, or reuse, the Company believes global demand for cleaner water supplies will multiply. Increasing need in water-short regions of the world, such as the Middle East and Asia, will precipitate the need for membrane technology. Many parts of Eastern Europe will need to upgrade their water treatment systems as they endeavour to become part of the European Economic Community. The rest of the world will need to upgrade existing plants or build new plants to ensure that quality requirements are met.

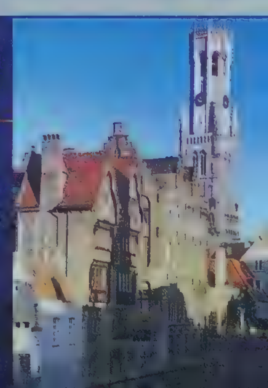
ZENON's new membrane production plant, currently under construction in Hungary, is expected to increase total production capacity two-fold once operational by the end of 2002. The potential exists for further expansion of the Hungary manufacturing plant, as future demand deems necessary.

In order to maintain its technological lead in the industry, the Company continues to be committed to ongoing research and development. This vision has produced product improvements and innovations such as the ZeeWeed® 500c, the industry-leading product for harder to treat water; and the ZeeWeed® 1000, the Company's latest addition for the drinking water market. Since its introduction to the marketplace in 2000, the ZeeWeed® 1000 has proven to be a successful product in meeting customer concerns about cost, energy, and operational efficiencies. Future generations of ZeeWeed® will continue to address these same issues.



Belgium

By combining ZeeWeed® technology with natural purification methods, Belgium is one of the first countries in the world to introduce a unique aquifer recharge system that features sound environmental practices for preserving our natural resources.



Competitive pressures will continue to increase because of the size of the market increase. ZENON believes that it will be successful in competing due to the ongoing product improvements that have been and will continue to be made.

ZENON will be entering the retail market in 2002 with the launch of the new Homespring™ point of entry water treatment system. This new product will ensure that the entire home is supplied with superior quality water.

Subsequent to the year-end, the Company completed the sale of 2 million non-voting Class A shares and 1 million common shares, for aggregate proceeds of approximately $42.5 million. These proceeds will be used to invest in the new membrane production facility in Hungary, the development and marketing of the Company's Homespring™ point of entry water treatment product, and for general corporate purposes. Subsequent to the year-end, a portion of the proceeds was used to repay the revolving term facility of $10 million. The Company is entering 2002 with very strong liquidity reflected in its balance sheet.

ZENON's management will continue to be diligent in controlling costs, streamlining operations, and improving profitability to meet revenue growth targets, which are expected to range between 20%-30%. Investments required to achieve this level of growth will also include an increase in the Company's workforce, although management does not foresee this percentage to equal that of revenue growth.

Poland

ZeeWeed® is treating alternative water sources, such as municipal wastewater, for use within power generation plants, conserving fresh water supplies.

Management's Responsibility for Financial Reporting

The accompanying financial statements of ZENON Environmental Inc. and all the information in this Annual Report are the responsibility of management and have been approved by the Board of Directors.

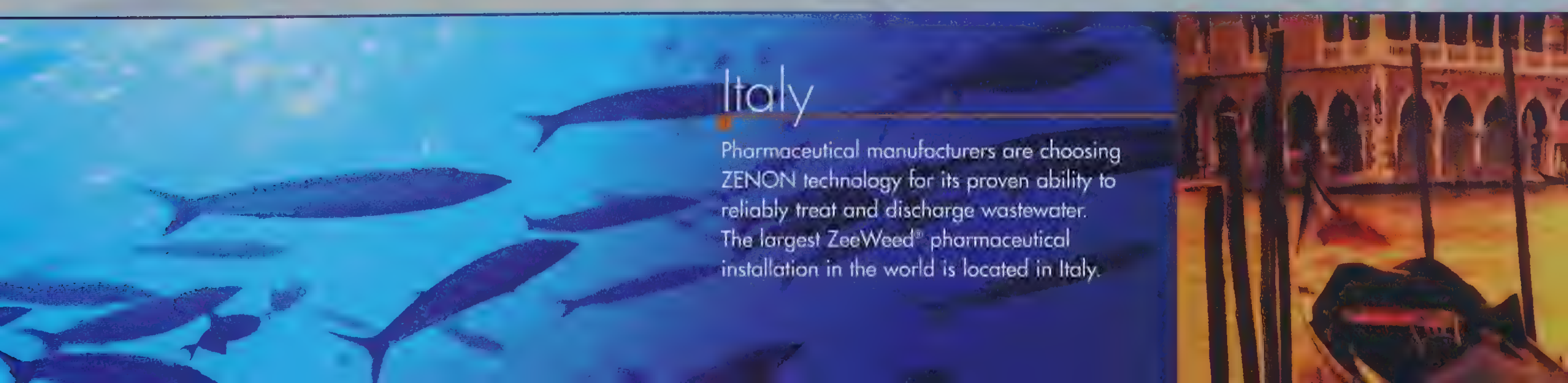
The financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles. When alternative accounting methods exist, management has chosen those it deems most appropriate in the circumstances. Financial statements are not precise since they include certain amounts based on estimates and judgements. Management has determined such amounts on a reasonable basis in order to ensure that the financial statements are presented fairly in all material respects. Management has prepared the financial information presented elsewhere in the Annual Report and has ensured that it is consistent with that in the financial statements. ZENON Environmental Inc. endeavours to maintain systems of internal accounting and administrative controls of high quality, consistent with reasonable cost. Such systems are necessary to provide reasonable assurance that the financial information is relevant, reliable and accurate, and that the Company's assets are appropriately accounted for and adequately safeguarded.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting, and is ultimately responsible for reviewing and approving the financial statements. The Board carries out this responsibility principally through its Audit Committee. The Audit Committee meets periodically with management, as well as the external auditors, to discuss internal controls over the financial reporting process, auditing matters and financial reporting issues, to satisfy itself that each party is properly discharging its responsibilities, and to review the Annual Report, the financial statements and the external auditors' report. The Committee reports its findings to the Board for consideration when approving the financial statements for issuance to the shareholders. The Committee also considers, for review by the Board and approval by the shareholders, the engagement or re-appointment of external auditors.

The Company's financial statements have been audited by Ernst & Young LLP, the external auditors, in accordance with Canadian generally accepted auditing standards on behalf of the shareholders. Ernst & Young LLP have full and free access to the Audit Committee.

Andrew Benedek
Chairman and
Chief Executive Officer

John E. Barker
Chief Financial Officer and
Vice President Finance



Auditors' Report

To the Shareholders of

ZENON Environmental Inc.

We have audited the consolidated balance sheets of ZENON Environmental Inc. as at December 31, 2001 and 2000 and the consolidated statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

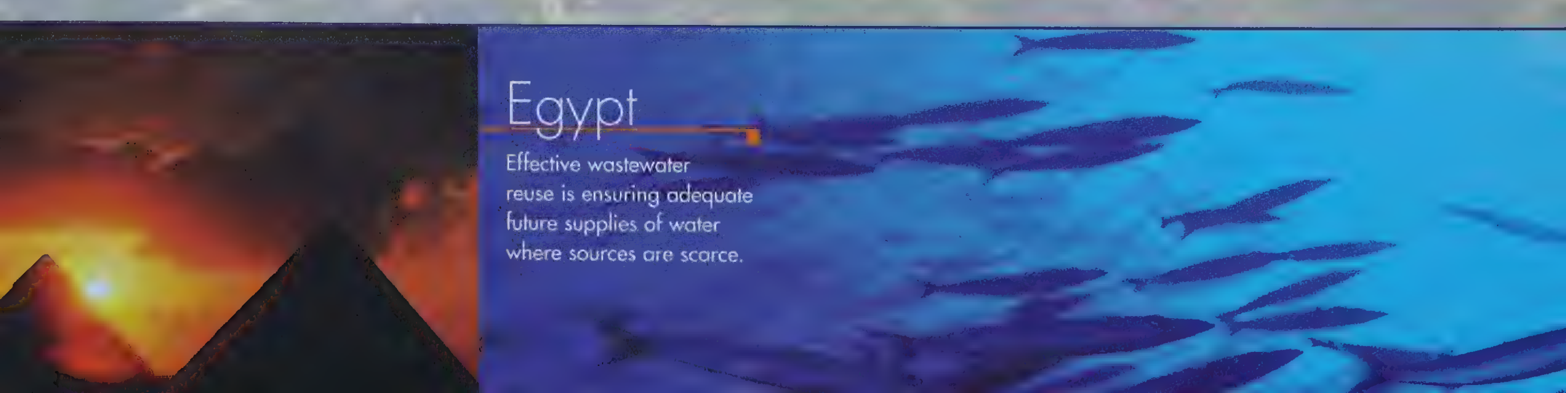
We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2001 and 2000 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Chartered Accountants
Toronto, Canada,

February 28, 2002



Consolidated Financial Statements

CONSOLIDATED BALANCE SHEETS

As at December 31

	2001 $	[000's]	2000 $
ASSETS [note 6]			
Current			
Cash and cash equivalents	**5,517**		4,203
Restricted cash	**233**		240
Accounts receivable [notes 3 and 16[iv]]	**40,702**		38,033
Accounts receivable - government funding [note 14]	**2,786**		2,916
Unbilled revenue	**20,678**		28,050
Inventories [note 2]	**8,788**		7,067
Prepaid expenses and deposits	**1,137**		834
Future income taxes [note 12]	**1,168**		524
Total current assets	**81,009**		81,867
Capital assets, net [note 4]	**52,087**		43,265
Patents, goodwill and other assets [note 5]	**14,943**		11,276
Future income taxes [note 12]	**746**		3,243
	148,785		139,651
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Bank indebtedness [note 6]	**529**		25,020
Accounts payable and accrued liabilities	**34,880**		22,836
Customer advances	**14,597**		5,283
Current portion of long-term debt [note 7]	**171**		169
Total current liabilities	**50,177**		53,308
Long-term debt [note 7]	**10,270**		10,282
Deferred technology credit [notes 14 and 16[ii]]	**5,000**		—
Total liabilities	**65,447**		63,590
Commitments and contingencies [notes 9 and 14]			
Shareholders' equity			
Capital stock [note 8]	**72,049**		69,733
Retained earnings	**13,795**		9,254
Cumulative translation adjustment	**(2,506)**		(2,926)
Total shareholders' equity	**83,338**		76,061
	148,785		139,651

See accompanying notes

Approved by the Board of Directors:

Andrew Benedek
Chairman and Chief Executive Officer

Andrew J. Szonyi
Director

CONSOLIDATED STATEMENTS OF INCOME

Years ended December 31

	2001 $	[000's except earnings per share]	2000 $
Revenue [note 11]	**124,711**		84,476
Cost of sales and services	**76,787**		56,376
Gross profit	**47,924**		28,100
Expenses			
Selling, general and administrative	**30,803**		26,344
Amortization	**8,172**		7,241
Interest, net [note 7]	**2,038**		1,847
	41,013		35,432
Operating income (loss) before the following	**6,911**		(7,332)
Gain on settlement agreement [note 10]	**—**		10,730
Operating income before income taxes	**6,911**		3,398
Provision for income taxes [note 12]	**2,290**		503
Net income for the year	**4,621**		2,895
Earnings per share [note 13]			
Basic	**$0.19**		$0.12
Diluted	**$0.19**		$0.12

See accompanying notes

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

Years ended December 31

	2001 $	[000's]	2000 $
Retained earnings, beginning of year	**9,254**		6,439
Net income for the year	**4,621**		2,895
Dividends on preference shares [note 8]	**(80)**		(80)
Retained earnings, end of year	**13,795**		9,254

See accompanying notes

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31

	2001 $	[000's]	2000 $
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income for the year	**4,621**		2,895
Add (deduct) items not affecting cash			
Amortization	**8,172**		7,241
Gain on disposal of capital assets	**(620)**		—
Future tax provision	**1,853**		(1,038)
Write-down on share purchase loans	**—**		269
Provision on investment	**—**		180
	14,026		9,547
Net change in non-cash working capital balances related to operations [note 17]	**24,625**		(13,870)
Cash flows provided by (used in) operating activities	**38,651**		(4,323)
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of capital assets	**(16,824)**		(21,549)
Proceeds on disposal of capital assets	**3,000**		170
Increase in patents, goodwill and other assets	**(6,127)**		(681)
Decrease in restricted cash	**24**		866
Increase in restricted cash	—		(1,106)
Acquisition [note 18]	—		(485)
Cash flows (used in) investing activities	**(19,927)**		(22,785)
CASH FLOWS FROM FINANCING ACTIVITIES			
Increase in bank indebtedness	**—**		19,347
Decrease in bank indebtedness	**(24,491)**		—
Increase in deferred technology credit	**5,000**		—
Proceeds from long-term debt	**90**		2,723
Repayment of long-term debt	**(25)**		—
Repayment of capital leases	**(75)**		(102)
Stock options exercised	**2,316**		653
Cash flows (used in) provided by financing activities	**(17,185)**		22,621
Effect of exchange rate changes on cash	**(225)**		14
Net increase (decrease) in cash during the year	**1,314**		(4,473)
Cash and cash equivalents, beginning of year	**4,203**		8,676
Cash and cash equivalents, end of year	**5,517**		4,203
Supplemental cash flow information			
Income taxes paid	**433**		1,096
Interest paid	**2,393**		2,119

See accompanying notes

Notes to Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of the significant accounting policies of ZENON Environmental Inc. [the "Company"]. The Company is incorporated under the laws of the Province of Ontario. Effective on the close of business on December 31, 2000, the Company amalgamated with its wholly-owned subsidiary, ZENON Environmental Systems Inc. The amalgamated company has continued as ZENON Environmental Inc. The Company is a leader in the manufacturing and use of membrane technology for water and wastewater treatment. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles.

Principles of consolidation

These consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany amounts and transactions have been eliminated upon consolidation.

Revenue recognition

Revenue from significant contracts is recognized on the percentage-of-completion basis. Under this method, in the calculation of revenue and profit earned, greater weighting is given to value added activities undertaken by the Company that are critical to the completion of the contracts, such as design, fabrication, assembly and installation of membrane systems. Contract cancellations are reflected in revenue once certainty exists regarding their collectibility. During 2001, revenue includes $2,921,000 related to the cancellation of a contractual arrangement. Revenue from all other contracts is recognized on the completed contract basis.

Although management uses its best estimates in determining contract revenue and costs, revisions in cost and profit estimates during the course of the contract can occur and are reflected in the period during which the need for the revision becomes known. Certain contracts contain penalty provisions based on performance relative to established targets. Such penalties are included in cost estimates when such amounts become effective and can be reasonably determined. Pre-contract direct selling costs such as bid and proposal costs are expensed as incurred. Only once the contract has been awarded are contract costs deferred and included in the percentage-of-completion calculations. For contracts where revenue is recognized on the percentage-of-completion basis, in situations where contract costs and related profit margins are in excess of amounts billed, these amounts are included in the caption unbilled revenue on the consolidated balance sheets. Where amounts billed are in excess of contract costs and related profit margins, then these amounts are included in customer advances.

Revenue from maintenance contracts is recognized on a straight-line basis over the term of the contract.

When the Company enters into distribution agreements, revenue from such agreements is recognized when the agreement is executed. Generally, these agreements do not commit the Company to any future obligations. Where such future obligations do exist, the Company defers revenue to cover these future obligations.

Warranty

Provisions for future warranty costs are made at the time the related revenue is recorded.

Cash and cash equivalents

All liquid investments with original maturities of three months or less are classified as cash and cash equivalents and are recorded at cost.

Inventories

Raw materials are stated at the lower of cost and replacement cost. Work in process and finished goods are stated at the lower of cost and net realizable value. Cost is generally determined on a first-in, first-out basis.

Capital assets

Capital assets are recorded at cost less related investment tax credits and government grants. Amortization is recorded using the straight-line method principally over the following periods:

Building	40 years
Machinery and equipment	3 - 8 years
Furniture and fixtures	5 - 8 years
Computer equipment and software	3 - 7 years
Automobiles	5 years

Leasehold improvements are amortized on a straight-line basis over the term of the lease.

Interest incurred on debt related to the buildings under construction is included in the cost of such assets.

Research and development costs

Research and development costs are expensed in the year in which they are incurred, except when development costs meet the criteria for deferral. Deferred product development costs are amortized on a straight-line basis over periods ranging from 3 to 5 years.

Government incentives

Non-repayable government incentives are accounted for using the cost reduction method whereby the incentives relating to current expenditures are deducted from the related expenditures and those relating to capital expenditures are applied to reduce the cost of the asset acquired. Government incentives with fixed repayment amounts are included on the consolidated balance sheets under the caption of deferred technology credit.

Patents and other assets

Patent costs are amortized on a straight-line basis over the life of the patent generally not exceeding 17 years. Included in other assets are deferred product development costs, which are amortized on a straight-line basis over periods not exceeding 5 years. Pre-operating costs associated with the commencement of new operations, which are generally related to the expansion of the Company's international service and sales network, are deferred until the new location is capable of commercial operations. Such costs are amortized on a straight-line basis over 3 years commencing with the date on which the new operation is capable of commercial operations. The recoverability of these costs is reviewed on an annual basis.

Goodwill

Goodwill represents the excess of the purchase price of businesses acquired over the fair value of the net assets acquired. Goodwill is being amortized over a period of 10-40 years with a weighted average period of 29 years.

The Company periodically assesses whether there has been any impairment in value based on the ability to recover the balance of the goodwill from expected future operating cash flows on an undiscounted basis. Any permanent impairment in the value of goodwill would be written-off against income.

Income taxes

The Company follows the liability method of tax allocation in accounting for income taxes. Under this method, future tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the substantively enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Stock-based compensation plan

No compensation expense is recognized when stock options are issued to employees. Any consideration paid by employees on exercise of stock options or purchase of stock is credited to capital stock.

Foreign currency translation

Revenue and expenses of self-sustaining foreign operations are translated into Canadian dollars at the average rates of exchange during the years. The assets and liabilities of such operations are translated at year-end rates. The resulting gain or loss on translation is recorded in shareholders' equity as a cumulative translation adjustment.

Transactions of Canadian operations denominated in foreign currencies are translated into Canadian dollars at the exchange rate in effect at the date of the transaction. Monetary assets and liabilities that are not hedged by foreign exchange contracts are translated into Canadian dollars at the exchange rate in effect at the consolidated balance sheet dates and the resulting exchange gain or loss is included in income. Monetary assets and liabilities that are hedged by foreign exchange contracts are translated at the effective hedge rate.

Earnings per share

Basic earnings per share is determined by dividing net income by the weighted average number of common and Class A shares outstanding in each respective period. Effective January 1, 2001, the Company retroactively adopted the Canadian Institute of Chartered Accountants' new recommendations on earnings per share. Under the new method the Company employs the treasury stock method instead of the imputed earning approach when computing diluted earnings per share. Under the treasury stock method, the exercise of options is assumed to have taken place at the beginning of the period [or at the time of issuance, if later]. The proceeds from the exercise are assumed to be used to purchase common stock at the average market price during the period. The incremental shares [the difference between the number of shares assumed issued and the number of shares assumed purchased] are included in the denominator of the diluted earnings per share calculation. There was no effect on fiscal 2000 earnings per share disclosures as a result of this adoption.

Use of estimates

The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Management believes that the estimates utilized in preparing its consolidated financial statements are reasonable and prudent; however, actual results could differ from those estimates.

2. INVENTORIES

Inventories consist of the following:

[000's]	2001 $	2000 $
Raw materials	**3,704**	2,754
Work in process	**2,952**	1,963
Finished goods	**2,132**	2,350
	8,788	7,067

3. RELATED PARTIES

As at December 31, 2001, a promissory demand loan of $765,000 bearing interest at prime plus 0.50% [year-end rate 4.5%] was due from an officer of the Company. The promissory demand loan was repaid subsequent to year end.

4. CAPITAL ASSETS

Capital assets are as shown in the table below:

Capital Assets 2001 [$000's]	**Cost**	**Accumulated amortization**	**Net book value**
Land	**5,029**	**—**	**5,029**
Building	**20,462**	**1,183**	**19,279**
Machinery and equipment	**28,620**	**12,864**	**15,756**
Furniture and fixtures	**2,913**	**1,657**	**1,256**
Computer equipment and software	**5,966**	**4,391**	**1,575**
Automobiles	**425**	**266**	**159**
Assets under construction or development	**9,033**	**—**	**9,033**
	72,448	**20,361**	**52,087**

Capital Assets 2000 [$000's]	Cost	Accumulated amortization	Net book value
Land	4,668	—	4,668
Building	19,260	746	18,514
Machinery and equipment	22,978	9,675	13,303
Furniture and fixtures	2,634	1,342	1,292
Computer equipment and software	5,526	3,670	1,856
Automobiles	440	295	145
Assets under construction or development	3,487	—	3,487
	58,993	15,728	43,265

No interest was capitalized during the year ended December 31, 2001 [2000 - $115,000].

5. PATENTS, GOODWILL AND OTHER ASSETS

Patents, goodwill and other assets consist of the following:

Patents, goodwill and other assets 2001 [$000's]	**Cost**	**Accumulated amortization**	**Net book value**
Patents	**4,144**	**1,201**	**2,943**
Goodwill	**6,156**	**1,546**	**4,610**
Deferred product development cost	**10,284**	**3,895**	**6,389**
Pre-operating costs and other	**2,561**	**1,560**	**1,001**
	23,145	**8,202**	**14,943**

Patents, goodwill and other assets 2000 [$000's]	Cost	Accumulated amortization	Net book value
Patents	3,281	806	2,475
Goodwill	6,156	1,267	4,889
Deferred product development cost	5,503	2,849	2,654
Pre-operating costs and other	2,571	1,313	1,258
	17,511	6,235	11,276

6. BANK CREDIT FACILITIES

In fiscal 2001, the Company and its subsidiaries entered into new agreements with certain of its bankers which, together with existing agreements, provide credit facilities that total $118.6 million. These facilities are made up as follows:

	2001 $	[000's]	2000 $
Revolving project finance demand facility	**1,700**		10,000
Demand facility	**49,300**		36,200
Revolving term facility [note 7]	**15,300**		10,000
Letter of credit facility [note 9[ii]]	**36,800**		23,800
Foreign exchange hedging facility [margin availability]	**15,500**		10,000
	118,600		90,000

Of these facilities at December 31, 2001, no amounts were utilized on the project finance facility [2000 - approximately $7.8 million], no amounts were utilized on the demand facility [2000 - approximately $17.2 million] and approximately $10 million of the revolving term facility was utilized [2000 - approximately $10 million]. In addition, approximately $4.7 million of the available foreign exchange contract margin of $15.5 million was also utilized [2000 - approximately $2.7 million]. The demand borrowings are limited to available margin on eligible accounts receivable, inventory and contract balances and can be accessed in either Canadian or U.S. dollars. All outstanding debt was in Canadian dollars. As collateral for these facilities, the Company has provided a general security agreement having a first priority security in personal property of the Company, including receivables, inventory and equipment and machinery. The demand facility bears interest at the Company's banker's prime rate plus 0.15% - 0.50% [2000 - banker's prime rate plus 0.75%] for either Canadian or U.S. dollar loans. The weighted average interest rate of the bank indebtedness in fiscal 2001 was approximately 6.9% [2000 - 7%]. The banking agreements are subject to certain restrictive financial covenants.

7. LONG-TERM DEBT

Long-term debt consists of the following:

	2001 $	[000's]	2000 $
Revolving term facility maturing in June 2006, with principal repayable in the amount of $2 million annually commencing in June 2002, plus interest at the bank's prime rate plus 1.25% [2000 - banker's prime rate plus 3/4%] *[notes 6 and 19]*	**10,000**		10,000
Obligations under capital leases	**182**		258
Government interest free loan repayable in the amount of $11,000 quarterly over five years [loan denominated in Hungarian Forints]	**162**		193
Government interest free loan to be repayable as follows: October 2005 - $88,000, September 2006 - $9,000 [loan denominated in Hungarian Forints]	**97**		—
	10,441		10,451
Less current portion	**171**		169
	10,270		10,282

The aggregate annual principal repayments required in respect of long-term debt other than the revolving term facility are as follows:

	$ [000's]
2002	171
2003	103
2004	46
2005	112
2006	9
	441

Interest expense on long-term debt during the year amounted to approximately $745,000 [2000 - $811,000].

8. CAPITAL STOCK

Capital stock consists of the following:

	2001 $	[000's]	2000 $
Authorized			
300,000, 2% cumulative, redeemable, convertible, voting Series 1 preference shares			
Unlimited non-voting, convertible, participating, Class A shares			
Unlimited number of common shares			
Issued			
300,000 [2000 - 300,000] Series 1 preference shares	**4,000**		4,000
3,900,000 [2000 - 3,900,000] non-voting Class A shares	**47,859**		47,859
20,413,752 [2000 - 19,795,642] common shares	**21,901**		19,585
	73,760		71,444
Less share purchase loans receivable	**(1,711)**		(1,711)
	72,049		69,733

The non-voting Class A shares are convertible into common shares on a share-for-share basis on June 10, 2008. Except with respect to voting and rights of conversion, the non-voting Class A shares have the same rights and are equal in all respects to common shares on a share-for-share basis. The Series 1 preference shares are redeemable at the Company's option for $13.33 per share plus any unpaid dividends. The Series 1 preference shares are convertible into common shares at any time at a conversion price equal to the weighted average trading price for the common shares during the five-day trading period immediately prior to conversion. As at December 31, 2001, there remains $320,000 of dividends payable related to the Series 1 preference shares. This amounts to approximately $1.07 per Series 1 preference share.

During 2001, the exercising of options resulted in the issue of 618,110 common shares for cash proceeds of approximately $2,316,000 [2000 - 252,350 common shares for proceeds of approximately $653,000].

During 2000, loans receivable in the amount of $1,381,000 for the purpose of purchasing shares of the Company were reclassified as a reduction of shareholders' equity, including loans for individuals who have left the employ of the Company. In this latter case, 100,000 non-voting Class A shares have been pledged by the former officers to the Company as non-recourse collateral for such loans. Subsequent to year-end all the loans from former employees were repaid.

During 2001, the Company amended the terms of the loans [note 16[ii]] of the current employees by extending the repayment terms and interest-free period. The loans are interest-free until July 31, 2003 and bear interest at the bank's prime rate of interest thereafter. The loans are repayable in four annual equal installments of principal plus accrued interest commencing on July 31, 2004 and ending July 31, 2007.

The outstanding loans receivable at December 31, 2001 relates to the purchase of 180,000 non-voting Class A shares. The average purchase price of the non-voting Class A shares was $11 per share.

Stock options

Under the terms of the option plan, options may be granted in an aggregate of up to but not exceeding 2,600,000 authorized but unissued common shares, and up to but not exceeding 280,000 non-voting Class A shares. The period during which an option is exercisable varies to a maximum not exceeding 10 years from the date the option is granted. The vesting period of the options varies from zero to five years.

A summary of the status of the Company's common share stock option plan as at December 31, 2001 and 2000 and the changes during the years then ended are as follows:

	2001 Number of shares #	2001 Weighted average exercise price $	2000 Number of shares #	2000 Weighted average exercise price $
Options outstanding, beginning of year	**1,315,252**	**6.32**	1,316,312	5.48
Granted during the year	**149,000**	**9.91**	326,000	7.23
Exercised during the year	**(618,110)**	**3.75**	(252,350)	2.59
Forfeited during the year	**(1,764)**	**4.74**	(74,710)	8.46
Options outstanding, end of year	**844,378**	**8.82**	1,315,252	6.32
Options exercisable, end of year	**523,558**		884,324	

As at December 31, 2001, the common share stock options outstanding were as follows:

		Options outstanding		Options exercisable	
Range of exercise prices $	**Number outstanding #**	**Remaining contractual life [years]**	**Weighted average exercise price $**	**Number exercisable #**	**Weighted average exercise price $**
5.00 to 5.90	**85,918**	**0.67 year**	**5.31**	**75,918**	**5.23**
6.45 to 9.25	**338,100**	**2.10 years**	**7.75**	**117,500**	**7.51**
9.37 to 9.87	**295,860**	**1.75 years**	**9.59**	**231,040**	**9.61**
10.45 to 15.29	**124,500**	**5.58 years**	**12.31**	**99,100**	**12.37**
	844,378			**523,558**	

A summary of the status of the Company's non-voting Class A share stock option plan as at December 31, 2001 and 2000 and the changes during the years then ended are as follows:

	2001 Number of shares #	2001 Weighted average exercise price $	2000 Number of shares #	2000 Weighted average exercise price $
Options outstanding, beginning of year	**190,100**	**12.18**	241,800	12.30
Granted during the year	**20,000**	**4.90**	—	—
Cancelled during the year	**(10,500)**	**12.75**	(51,700)	12.75
Options outstanding, end of year	**199,600**	**11.42**	190,100	12.18
Options exercisable, end of year	**114,160**		82,440	

As at December 31, 2001, the non-voting Class A share stock options outstanding were as follows:

		Options outstanding		Options exercisable	
Range of exercise prices $	**Number outstanding #**	**Remaining contractual life [years]**	**Weighted average exercise price $**	**Number exercisable #**	**Weighted average exercise price $**
4.90	**20,000**	**4.3 years**	**4.90**	**4,000**	**4.90**
7.35	**20,000**	**2.8 years**	**7.35**	**12,000**	**7.35**
12.75	**159,600**	**2.6 years**	**12.75**	**98,160**	**12.75**
	199,600			**114,160**	

9. COMMITMENTS AND CONTINGENCIES

[i] The Company is committed to future minimum annual lease payments under various operating leases as follows:

[000's]	Real property $	Equipment $	Total $
2002	622	1,146	1,768
2003	452	890	1,342
2004	368	592	960
2005	367	350	717
2006	262	164	426
	2,071	3,142	5,213

[ii] The Company provides certain warranties on its products and services. At December 31, 2001, a liability of $3.0 million for future warranty costs, based on past experience and management's best estimates, has been included in accounts payable and accrued liabilities [2000 - $1.0 million]. In addition, the Company has performance bonds and letters of credit outstanding under product manufacturing and service contracts totalling approximately $32.8 million [2000 - approximately $33 million] and $15.9 million [2000 - approximately $9.5 million], respectively.

[iii] As at December 31, 2001, the Company is committed to capital asset purchases of approximately $0.7 million [2000 - nil]. In addition, the Company has approved approximately $24 million of capital expenditures for 2002.

10. SETTLEMENT AGREEMENT

During fiscal 2000, pursuant to a settlement for disputes arising from an alleged contravention by the other party to an agreement for the joint development and exploitation of the Company's membrane technology, a payment of $10.7 million, net of costs, was received.

11. REVENUE

During 2001, revenue of $2,926,000 was recorded that related to distribution agreements that allow distributors to assemble water and wastewater treatment systems using the Company's proprietary immersed membrane technology [2000 - $1,443,000].

12. INCOME TAXES

Effective January 1, 2000, the Company changed its method of accounting for income taxes from the deferral method to the liability method of tax allocation, as required by The Canadian Institute of Chartered Accountants' Section 3465, "Accounting for Income Taxes". As permitted under the new rules, prior years' consolidated financial statements have not been restated. The cumulative effect of this change as of January 1, 2000 was to increase future income tax assets and open retained earnings by $1.0 million.

[i] Future income tax assets and liabilities consist of the following temporary differences:

	2001 $	[000's]	2000 $
Assets			
Non-deductible reserves	**923**		524
Loss carryforwards	**—**		929
Undeducted scientific research and experimental development expenses	**1,746**		1,988
Undeducted financing costs	**245**		466
Tax benefit of investment tax credits	**430**		1,080
	3,344		4,987
Liabilities			
Capital assets	**(411)**		(231)
Other assets	**(1,019)**		(989)
	(1,430)		(1,220)
Total future income taxes	**1,914**		3,767
Future income taxes - current	**1,168**		524
Future income taxes - long-term	**746**		3,243
	1,914		3,767

[ii] The details of the provision for income taxes are as follows:

	2001 $	[000's]	2000 $
Current provision			
Current income taxes	**1,175**		1,501
Reduction in income tax expense from previously unrecognized tax loss	**(841)**		(313)
Federal large corporations tax	**185**		192
Other	**(82)**		161
	437		1,541
Future provision			
Future income taxes	**1,853**		1,080
Previously unrecognized future income tax assets	—		(2,002)
Effect of changes in tax rates	—		(116)
	1,853		(1,038)
Total provision for income taxes	**2,290**		503

[iii] The provision for income taxes differs from the amounts which would be obtained by applying Canadian statutory rates to operating income before income taxes. The differences result from the following items:

	2001 $	[000's]	2000 $
Canadian statutory income tax rate	**41.87%**		43.6%
Provision for income taxes at Canadian statutory rates	**2,893**		1,482
Manufacturing and processing profits deduction	**(363)**		(435)
Foreign income tax differential	**107**		1,477
Effect of income taxed at capital rates	—		(741)
Federal large corporations tax	**185**		192
Future income tax assets not previously recognized	**(1,210)**		(2,002)
Current year losses not recognized	**252**		646
Effect of changes in tax rates	—		(116)
Other	**426**		—
Total provision for income taxes	**2,290**		503

[iv] The Company has unclaimed deductions for tax purposes and tax loss carryforwards of approximately $3.6 million [2000 - $7.6 million] for which no benefit has been recorded in the accounts. The estimated after-tax value of these attributes is approximately $1.5 million [2000 - $1.7 million]. Of these aggregate amounts, $2.3 million will start to expire in 2008 and the remainder has no expiry date. In addition, the Company has investment tax credits of approximately $0.8 million for which no benefit has been recorded in the accounts. These credits may be applied against future income taxes payable. The rights to claim these credits expire in varying amounts in 2009 and 2010.

[v] The Company has not provided for withholding tax on unremitted retained earnings of foreign subsidiaries, as such earnings are expected to remain permanently invested.

13. EARNINGS PER SHARE

The weighted average number of shares outstanding during the year was 23,883,165 [2000 - 23,595,000].

14. RESEARCH AND DEVELOPMENT COSTS

During the year, the Company incurred approximately $6,920,000 [2000 - $6,888,000] in research and development costs.

During 2000, the Company entered into an agreement with Technology Partnerships Canada ["TPC"], which will provide funding from TPC for a three-year period up to a maximum of approximately $9.9 million for a specific research contract. As at December 31, 2001 approximately $6.2 million has been claimed under the TPC agreement of which approximately $1.2 million was deducted from other assets, while $5.0 million was reflected on the consolidated balance sheets under the caption deferred technology credit. Of the $6.2 million claimed, approximately $3.5 million [2000 - nil] has been received while the remaining amount of approximately $2.7 million [2000 - $2,916,000] is reflected as accounts receivable. If certain aspects of this project are successful, the Company is obligated to pay to TPC a royalty based on the total unconsolidated revenue of the Company. The agreement contemplates that this royalty will have both a minimum and maximum amount.

During 2001, other than TPC, total incentives under various government programs and from other sources in respect of certain qualifying expenditures amounted to approximately $1,282,000 [2000 - $1,213,000], which have been applied against the related cost.

Repayment of certain incentives received in the current and prior years is required, if the research and development results in marketable products. If this occurs, the repayment is in the form of a royalty based on a percentage of the resulting sales revenue for a fixed period of time. Such royalties are charged to income when incurred.

The Company is also entitled to receive an investment tax credit for qualifying research and development costs incurred.

15. SEGMENTED INFORMATION

The Company operates in Canada, the United States, Europe, Asia, and the Middle East, in the water treatment industry. Its reportable operating segments are strategic business units that offer membrane-based systems for water and wastewater treatment. These segments are managed separately as each business unit requires a different market strategy.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company accounts for intersegment sales at agreed upon prices, which recognizes the research and development costs incurred in the development of membranes.

Operations and identifiable assets by operating segment are presented below. External sales are allocated on the basis of sales to external customers.

Operating segments

[000's]	Technology, membranes and corporate 2001 $	Technology, membranes and corporate 2000 $	North America systems 2001 $	North America systems 2000 $	Europe, Asia and Middle East systems 2001 $	Europe, Asia and Middle East systems 2000 $	Total 2001 $	Total 2000 $
Revenue from external customers	**243**	1,859	**94,800**	61,376	**29,668**	21,241	**124,711**	84,476
Intersegment revenue	**28,199**	17,616	**1,313**	91	**485**	1,375	**29,997**	19,082
Amortization of capital assets [1]	**3,783**	2,554	**3,373**	3,605	**1,016**	1,082	**8,172**	7,241
Segment income (loss) before interest and taxes	**(2,095)**	12,934	**7,779**	(3,872)	**3,646**	(3,455)	**9,330**	5,607
Total assets	**97,449**	106,531	**42,558**	26,327	**8,778**	6,793	**148,785**	139,651
Capital assets expenditures [1]	**15,224**	12,502	**4,361**	5,785	**3,366**	1,769	**22,951**	20,056

Reconciliation of income

[000's]	2001 $	2000 $
Total income for reportable segments	**9,330**	5,607
Elimination of intersegment profit	**(381)**	(362)
Interest, net	**(2,038)**	(1,847)
Provision for income taxes	**(2,290)**	(503)
Net income for the year	**4,621**	2,895

External sales and capital assets by jurisdiction are presented below:

[000's]	Canada 2001 $	Canada 2000 $	United States 2001 $	United States 2000 $	Europe, Asia and Middle East 2001 $	Europe, Asia and Middle East 2000 $	Total 2001 $	Total 2000 $
External sales	**41,328**	30,966	**53,715**	32,269	**29,668**	21,241	**124,711**	84,476
Capital assets [1]	**60,356**	49,273	**1,147**	1,637	**5,527**	3,631	**67,030**	54,541

[1] Includes patents, goodwill and other assets

16. FINANCIAL INSTRUMENT AND RISK MANAGEMENT

[i] The Company enters into either forward foreign exchange contracts or foreign exchange options to sell specific amounts of U.S. dollars to Canadian dollars at set future dates at predetermined exchange rates. The contracts are matched with anticipated U.S. dollar cash flows. The Company enters into the forward foreign exchange contracts to protect itself from the possibility of loss should the value of the U.S. dollar decline relative to the Canadian dollar.

The amount of anticipated future export sales receipts in U.S. dollars are projected in light of current conditions in the Company's market in the U.S., existing orders from customers, and the Company's past experience in similar

circumstances. Management has set a risk management objective of hedging approximately 80% of all significant foreign currency denominated sales at the time of the contract award.

As at December 31, 2001, based upon a spot rate of $1 U.S. = $1.6084 Cdn., the Canadian dollar amounts to be received under foreign currency options are $46.7 million. The weighted contractual exchange rate is $1 U.S. = $1.5944 Cdn. and the settlement dates of outstanding options are all less than one year. The unrecognized loss on hedges of anticipated future U.S. dollar revenue was approximately $222,000 [2000 - unrecognized gain of approximately $227,000].

[ii] The Company's estimate of the fair value of other financial instruments, which includes receivables, unbilled revenue, loans receivable, payables, long-term debt and interest-free government loans, approximates their carrying value, except for loans receivable. The fair market value of these loans for present employees at December 31, 2001, using a 5% discount rate, is $815,000. The fair market value of the deferred technology credit using a 5% discount rate is $3,795,000.

[iii] The concentration of credit risk in accounts receivable is limited due to the Company's large customer base, geographic dispersion of its customers and deposits received from customers. In addition, in its largest business sector the Company deals with various levels of government where the risk of credit loss is less than with the private sector. Certain of the Company's projects in the government sector can be subject to delays due to the timing of the customers' funding arrangements. Many projects in excess of $1.0 million are secured with material and labour payment bonds/performance bonds or letters of credit.

[iv] While the Company has many customers, one customer represents 12% of the accounts receivable balance while two other customers represent 38% of the unbilled revenue as at December 31, 2001. [As at December 31, 2000, one customer represented 22% of the accounts receivable balance and 24% of the unbilled revenue and approximately 12% of revenue.]

17. CONSOLIDATED STATEMENTS OF CASH FLOWS

The net change in non-cash working capital balances related to operations consists of the following:

	2001		2000
	$	[000's]	$
Accounts receivable	**(2,584)**		(22,873)
Unbilled revenue	**7,509**		(48)
Inventories	**(1,752)**		900
Prepaid expenses and deposits	**(307)**		172
Accounts payable and accrued liabilities	**12,273**		5,399
Customer advances	**9,486**		2,580
	24,625		(13,870)

18. ACQUISITION

In May 2000, the Company acquired the assets of a business located in the United States for approximately $323,000 U.S. [approximately $485,000 Cdn.] including transaction costs. The purchase price was allocated as follows:

	[000's]	$
Non-cash working capital		388
Capital assets		13
Goodwill		84
Cash consideration		485

19. SUBSEQUENT EVENTS

On February 13, 2002, the Company completed the sale of 1,739,130 non-voting Class A shares and 869,565 common shares. The aggregate proceeds were $36,999,990. In addition, an over-allotment option for 260,870 non-voting Class A shares and 130,435 common shares was exercised on February 26, 2002. The aggregate proceeds were $5,550,009. A portion of the total proceeds was used to repay the revolving term facility of $10 million.

20. COMPARATIVE CONSOLIDATED FINANCIAL STATEMENTS

The comparative consolidated financial statements have been reclassified from statements previously presented to conform to the presentation of the 2001 consolidated financial statements.

Board of Directors

1. **Andrew Benedek** is the Chairman of the Board, Chief Executive Officer, and the founder of ZENON Environmental Inc. He obtained his Ph.D. in chemical engineering in 1970 and joined the engineering faculty at McMaster University in Ontario. ZENON was formed in 1980 on his vision of a world where cost effective membrane technology could ensure humanity's survival by providing safe and superior quality water.

2. **John A. Coburn** is a Corporate Director and is Senior Vice President for ZENON with responsibility for international operations. Since joining ZENON in 1982, he has served in virtually all of its major operating areas. In 1982, he was awarded the Government of Canada Merit Award for dedication, devotion and excellence of work with respect to the analysis of toxic substances in the Great Lakes.

3. **David Colcleugh** is Chairman, President and Chief Executive Officer of DuPont Canada Inc. Mr. Colcleugh also sits on the Board of Directors of the Hudson's Bay Company, the Canadian Chemicals Producers' Association, the Textiles Human Resources Council and the Art Gallery of Mississauga. ● ■

4. **The Honourable Frank McKenna** is Senior Partner with McInnes Cooper, Barristers and Solicitors in Atlantic Canada. He was the Premier of New Brunswick from 1987 to 1997. Mr. McKenna devotes his energies to the practice of law, and corporate directorships that include Noranda Inc., Marsh Canada Limited, CanWest Communications Corp., Bank of Montreal and General Motors of Canada. ▲

5. **The Honourable Maurice Strong** is Special Advisor to the Secretary General of the United Nations and President of the University for Peace. He is the former President, Chairman and Chief Executive Officer of Ontario Hydro and Petro Canada. His career has included appointments such as the Senior Advisor to the President of The World Bank, among others. ▲

6. **Andrew J. Szonyi** is Executive Vice President and Partner in First Nations Equity Inc., an Aboriginal investment banking firm. Dr. Szonyi has extensive experience as a financial and management consultant, and is a corporate director of several public and private corporations. ● ■ ▲

7. **Samir J. Zalzal** is an independent business consultant. He is also the retired President and Chief Executive Officer of Ingersoll-Rand Canada Inc. Mr. Zalzal joined Ingersoll-Rand in 1967 and held various positions within the company. He is an active supporter of numerous industrial associations that include the Canadian Society for Mechanical Engineering and the American Institute of Plant Engineers, among others. ● ■

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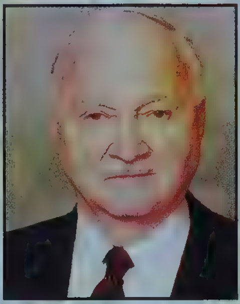

6.


7.


● Audit Committee

■ Human Resources Committee

▲ Corporate Governance and Nominating Committee

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Chairman of the Board and Chief Executive Officer

Rafael Simon
Chief Operating Officer

John E. Barker
Chief Financial Officer and Vice President Finance

John A. Coburn
Senior Vice President

Pierre Côté
Chief Technology Officer

Diana Mourato
Vice President Municipal

Bill Bonkoski
Vice President Industrial

Upen Bharwada
Vice President Membrane Technology

Ian Crossley
Chief Engineer

Auditors

Ernst & Young LLP
Toronto, Ontario

Principal Bankers

CIBC
Hamilton, Ontario

Scotiabank
Toronto, Ontario

Share Listing

The shares of ZENON Environmental Inc. are listed for trading on The Toronto Stock Exchange under the symbols "ZEN" and "ZEN.A."

ZEN.A shares (non-voting Class A shares) are identical to ZEN common shares except with respect to voting and rights of conversion. On June 10, 2008, ZEN.A shares will automatically convert into ZEN shares on a share-for-share basis.

A copy of the Company's Annual Report may be obtained, without charge, upon request directed to ZENON's Corporate Headquarters, to the attention of the Investor Relations Department.

You may also visit us on the web at
www.zenonenv.com

Investor Information

Shareholders who need information on transferring shares, lost certificates, change of address, or canceling duplicate mailings, should contact ZENON's transfer agent CIBC Mellon Trust Company at 1-800-387-0825.

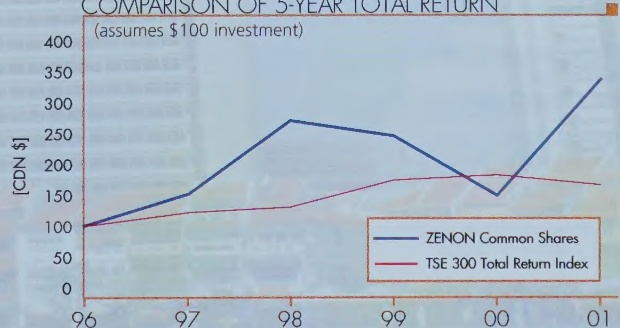
Transfer Agent & Registrar:

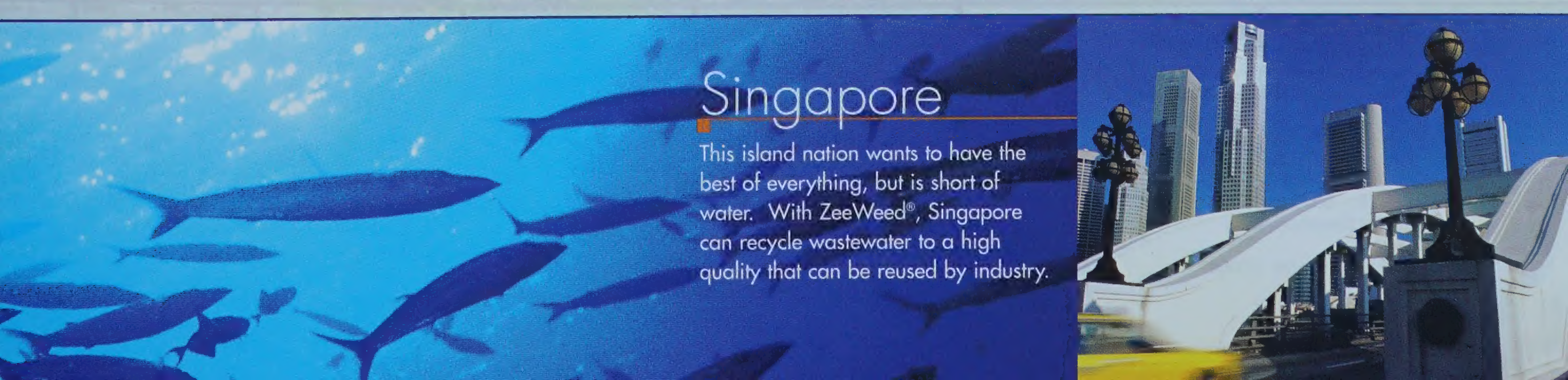
CIBC Mellon Trust Company
320 Bay Street
P.O. Box 1
Toronto, Ontario M5H 4A6
Canada

Notice of Annual Meeting

Shareholders are invited to attend ZENON's Annual Meeting to be held on Thursday, May 16, 2002 at 4:30 p.m. at our Corporate Headquarters located at 3239 Dundas Street West, Oakville, Ontario.

COMPARISON OF 5-YEAR TOTAL RETURN





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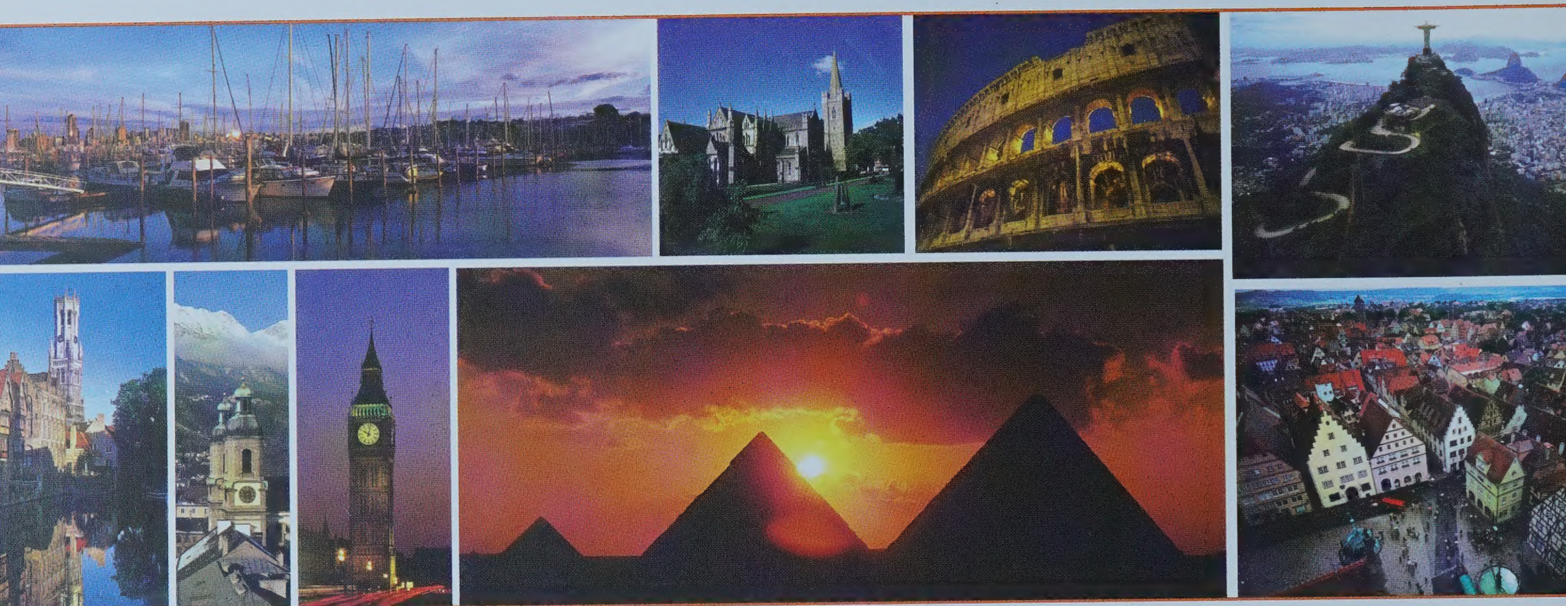
Mission Statement

We are dedicated to solving urgent problems of humanity associated with water supply and wastewater management through advanced technology.

We serve our customers with technological solutions of exceptional quality and value.

As a team of dedicated employees, we benefit from professional growth, mutual respect, Company ownership and the satisfaction that our success improves the environment we all share.

Over the long term, we provide our shareholders with a superior return on their investment.



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